No. 96-1364

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1996

SHEA & GOULD and SHELDON CAMHY,

Petitioners,

vs.

RONALD L. DURKIN, Trustee of the Benchmark Irrevocable Trust,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR PETITIONERS

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15 pp

TABLE OF CONTENTS

	Page
Table of Citations	ii
Introduction	1
Further Reasons for Granting the Writ	3
I. Respondent Overlooks The Very Essence Of Shareholder Derivative Litigation.	3
A. By Definition, A Derivative Action Is Prosecuted By Shareholders For The Corporation.	3
B. Creditors Have No Standing In Derivative Actions.	4
C. Respondent Belittles The Role Of The District Court In Derivative Action Settlements.	6
D. Respondent Ignores That The Very Purpose Of Rules 23 And 23.1 Is To Provide A Full And Fair Opportunity To Litigate.	7
II. The Resolution Of This Case Turns On Federal, Not State, Law.	8
III. A Conflict Exists Among The Circuits.	9
Conclusion	10

Contents

Page

Cases Cited:

Brooks v. Weiser, 57 F.R.D. 491 (D.N.Y. 1972) 4

Credit Lyonnais Bank Nederland, N.V. v. MGM-Pathe Communications Co., 1991 Del. Ch. LEXIS 215 (Dec. 30, 1991) 4

Dodge v. First Wisconsin Trust Co., 394 F. Supp. 1124 (E.D. Wis. 1975) 4

Dorfman v. Chemical Bank, 56 F.R.D. 363 (D.N.Y. 1972) 4

In re Imperial Corp. of America, 92 F.3d 1503 (9th Cir. 1996) 7

In re Oracle Sec. Litig., 829 F. Supp. 1176 (N.D. Cal. 1993) 6, 7, 8

Kamen v. Kemper Fin. Servs., 500 U.S. 90 (1991) ... 3

Kamilewicz v. Bank of Boston Corp., 100 F.3d 1348 (7th Cir. 1996) 10

Kauffman v. Dreyfus Fund, Inc., 434 F.2d 727 (3d Cir. 1970) 5

Kusner v. First Pennsylvania Corp., 395 F. Supp. 276 (E.D. Pa. 1975), *rev'd in part on other grounds*, 531 F.2d 1234 (3d Cir. 1976) 4, 5

Contents

	Page
Laskey v. International Union, 638 F.2d 954 (6th Cir. 1981)	9
Maher v. Zapata Corp., 714 F.2d 436 (5th Cir. 1983)	6
Mathes v. Roberts, 85 F.R.D. 710 (S.D.N.Y. 1980)	6
Owen v. Modern Diversified Industries, Inc., 643 F.2d 441 (6th Cir. 1981)	4, 5
Phillips Petroleum Co. v. Shutts, 472 U.S. 797 (1985)	7
Starr v. State Mutual Investors, 611 F.2d 375 (6th Cir. 1979)	5
Weinberger v. Kendrick, 698 F.2d 61 (2d Cir. 1982)	6
Zimmerman v. Bell, 800 F.2d 386 (4th Cir. 1986)	6
Statute Cited:	
11 U.S.C. § 547	6
Rules Cited:	
Fed. R. Civ. P. Rule 23	1, 2, 3, 7, 9, 10
Fed. R. Civ. P. Rule 23.1	*passim*

Contents

Page

Other Authorities Cited:

7C WRIGHT, MILLER & KANE, FEDERAL PRACTICE AND PROCEDURE § 1839, p. 186 (2d ed. 1986) 8

Liss, *Broad-Based Malpractice Suit Filed,* L.A. Daily J., March 27, 1997, at 2, col. 2 2

Winnike, *Credit Lyonnais: An Aberration or An Enhancement of Creditors' Rights in Delaware?* 6 No. 7 INSIGHTS 31 (1992) 4

INTRODUCTION

Respondent argues that his "legal malpractice" claim is not really a collateral attack on a federal judgment approving a representative case settlement. This argument exalts form over substance and ignores the reality that such a claim strikes at the core purpose of court-approved settlements under Rule 23 and 23.1 — the achievement of finality. That the Court of Appeals' decision undermines the finality of such judgments is brought vividly into focus by a newly reported case, now sanctioned by the decision of the court below.

On March 27, *The Los Angeles Daily Journal* reported:

> More than 100 individuals from across the country have filed a legal malpractice suit against six law firms and 18 individual lawyers, alleging that a settlement reached in a securities class action benefited the attorneys who reached the agreement and not the plaintiffs.
>
> * * *
>
> Herbert Milstein, a named defendant . . . , said that he . . . believed the settlement reached was beneficial to the class members.
>
> "My memory is that it was a settlement that was in the best interests of the class at the time," Milstein said.
>
> He added that the settlement provisions were made available to the class members to review and they had an opportunity to opt out of the agreement. Milstein said that U.S. District Judge John G. Davies, who presided over the Rodney King civil rights trial, ratified the settlement.

Liss, *Broad-Based Malpractice Suit Filed*, L.A. Daily J., March 27, 1997, at 2, col. 2.

Respondent does not dispute that the *Shields* court properly applied Rule 23 and 23.1, finding that the Shareholder Plaintiffs were adequate derivative case fiduciaries and that the settlement was fair, adequate and reasonable to ICA. He also concedes that the *Shields* court entered a valid and binding judgment. In the next breath, however, Respondent argues that he should not be bound by the judgment's specific findings and should be permitted to continue his attack on the judgment unabated.

Like the Ninth Circuit in the case below, Respondent reaches his conclusion by: (i) ignoring the very essence of a shareholder derivative action as a lawsuit prosecuted by a shareholder to enforce corporate rights; (ii) making false and inflammatory charges of collusion and fraud on the court, even though those claims have never been pled; (iii) belittling the vital role of the district court in this and all other derivative case settlements; and (iv) accusing the settling *Shields* parties, oddly, of a common desire to obtain approval of the settlement — a necessary condition to any settlement.

Respondent attempts to minimize the conflict among the circuits by completely ignoring the authorities holding that there is a "strong judicial policy that favors settlement," especially in complex derivative and class actions. Respondent would have the Court believe that because this precise fact pattern is not presented in other Court of Appeals opinions, there is no conflict among the circuits. Respondent's argument is misguided and deceptive. This case presents squarely a vital issue of federal policy: Can a federal judgment resolving representative litigation in full compliance with Rule 23 and 23.1 based upon findings of fairness and adequate representation be avoided by the mere allegation of "malpractice" or "breach of fiduciary duty?"

FURTHER REASONS FOR GRANTING THE WRIT

I. RESPONDENT OVERLOOKS THE VERY ESSENCE OF SHAREHOLDER DERIVATIVE LITIGATION.

Respondent does not dispute that the underlying *Shields* action was a valid shareholder derivative action. Nor does Respondent dispute that the *Shields* court properly found that the Shareholder Plaintiffs were appropriate derivative case fiduciaries, and then properly applied Rule 23 and 23.1 in finding that the proposed settlement was fair, adequate and reasonable to ICA. Instead, Respondent ignores the legal implications of these findings.

A. By Definition, A Derivative Action Is Prosecuted By Shareholders For The Corporation.

> The derivative form of action permits an individual shareholder to bring "suit to enforce a *corporate* cause of action against officers, directors, and third parties." . . . Devised as a suit in equity, the purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation . . .

Kamen v. Kemper Fin. Servs., 500 U.S. 90, 95 (1991) (emphasis in original and citation omitted). As a valid derivative action, ICA's interests as a plaintiff were in the hands of the Shareholder Plaintiffs.

Shea & Gould did not represent the Shareholder Plaintiffs. Respondent's unsupported assertion that Shea & Gould represented "ICA as a plaintiff in the derivative case" has no basis in law or fact. Indeed, at the conclusion of the *Shields* action, the district court awarded a substantial fee to the counsel who represented ICA's interests as a plaintiff — the Shareholder Plaintiffs' lawyers.

Based on this failure to recognize the essential nature of a derivative action, Respondent argues, and the Court of Appeals held, that the *Shields* court only determined whether the Shareholder

Plaintiffs adequately represented other shareholders, not the "full corporate interests of ICA." This argument is contradicted by Rule 23.1 itself. Rule 23.1, on its face, provides that while status as a shareholder is required for standing in a derivative action, the shareholder must be found to be an adequate representative "in enforcing the right of the corporation." Fed. R. Civ. P. 23.1; *see also Owen v. Modern Diversified Industries, Inc.*, 643 F.2d 441, 443 (6th Cir. 1981) (Rule 23.1 requires "the representative plaintiff must bring the derivative action primarily to enforce the right of the corporation.")

B. Creditors Have No Standing In Derivative Actions.

Respondent's principal accusation is that Shea & Gould allegedly failed to protect the interests of ICA's creditors in the *Shields* action.[1] This allegation is also one of the reasons offered by the Court of Appeals for affirming the district court's decision. However, as a matter of law, creditors have no standing in Rule 23.1 derivative actions. The Court of Appeals' decision conflicts with the decisions of other circuits in this respect as well.

Creditors have no standing in Rule 23.1 derivative actions. *See, e.g., Kusner v. First Pennsylvania Corp.*, 395 F. Supp. 276, 280-81 (E.D. Pa. 1975), *rev'd in part on other grounds*, 531 F.2d 1234 (3d Cir. 1976); *Dodge v. First Wisconsin Trust Co.*, 394 F. Supp. 1124, 1127 (E.D. Wis. 1975); *Brooks v. Weiser*, 57 F.R.D. 491, 494, 495 (D.N.Y. 1972); *Dorfman v. Chemical Bank*, 56 F.R.D. 363, 364 (D.N.Y. 1972). "[O]nly a proprietary interest in a business

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1. Respondent argues that because ICA was allegedly within the "vicinity" of insolvency, fiduciary duties to the corporation's creditors arose. This argument is based on a Delaware Chancery Court decision, *Credit Lyonnais Bank Nederland, N.V. v. MGM-Pathe Communications Co.*, 1991 Del. Ch. LEXIS 215, *108 (Dec. 30, 1991). *Credit Lyonnais*, however, was decided nearly ***two years after*** the *Shields* settlement. If this controversial decision were followed, it would change the law of corporate fiduciary duties. *See* Winnike, *Credit Lyonnais: An Aberration or An Enhancement of Creditors' Rights in Delaware?*, 6 No. 7 INSIGHTS 31 (1992). Respondent has never cited (nor can we find) a court decision anywhere holding corporate counsel to the standard of care suggested in *Credit Lyonnais*.

entity invests a party with the requisite legal standing to prosecute a secondary or derivative action." *Kusner*, 395 F. Supp. at 280. *Kusner* explained: "Standing is justified only by this proprietary interest created by the stockholder relationship and the possible indirect benefits the nominal plaintiff may acquire *qua* stockholder of the corporation which is the real party in interest. Without this relationship, there can be no standing . . ." *Id.* (quoting *Kauffman v. Dreyfus Fund, Inc.*, 434 F.2d 727, 735 (3d Cir. 1970)). Rule 23.1 "acknowledges the necessity of shareholder standing in derivative actions, and expressly commands that in pleading such an action the plaintiff allege to have been a shareholder at the time of the transaction of which he complains." *Id.* at 280-81.

Owen v. Modern Diversified Industries, Inc. illustrates this rule. There, the holder of 24 shares of stock in the defendant corporation, whose value did not exceed $21 and debentures of the same corporation with a face value of $34,900, brought a derivative action under Rule 23.1. The district court held the plaintiff could not adequately represent the corporation's interests: "We hold that a person who owns a negligible amount of stock in a corporation and holds corporate debentures in substantial amounts, cannot bring a shareholder derivative action for the admitted purpose of protecting his interest as a creditor of the corporation." *Owen*, 643 F.2d at 443. The Court of Appeals affirmed.[2] *Id.*; *see also Starr v. State Mutual Investors*, 611 F.2d 375 (6th Cir. 1979) (" . . . holders of convertible debentures are not entitled to bring derivative actions under Rule 23.1 . . . because the Rule expressly limits the right to maintain derivative actions to shareholders.")

Respondent argues, and the Court of Appeals held, that issue preclusion cannot apply because Shea & Gould might be held liable for failing to protect the rights of ICA's creditors. This holding

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2. The court explained: "The language of Rule 23.1 . . . imposes, among others, two requirements. First, the representative plaintiff must fairly and adequately represent the interests of the similarly situated shareholders. Second, the representative plaintiff must bring the derivative action primarily to enforce the right of the corporation." *Id.*

conflicts with *Owen*, *Starr* and every other case holding that creditors have no standing in a derivative action.[3]

C. Respondent Belittles The Role Of The District Court In Derivative Action Settlements.

Contrary to Respondent's assertions, Rule 23.1 requires that *the court* determine whether a derivative action settlement "fairly and adequately serves the interests of the corporation on whose behalf the derivative action was instituted." *Mathes v. Roberts*, 85 F.R.D. 710, 713 (S.D.N.Y. 1980); *accord Zimmerman v. Bell*, 800 F.2d 386, 391 (4th Cir. 1986); *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1186 (N.D. Cal. 1993). The court does not act merely as a referee, but is expected to exercise its independent judgment to determine fairness. *Weinberger v. Kendrick*, 698 F.2d 61, 69 n. 10 (2d Cir. 1982). To reach that conclusion, the court is required to determine that there was no fraud or collusion in arriving at the settlement agreement and that the agreement was reached through arm's length negotiations. *Zimmerman*, 800 F.2d at 391; *Maher v. Zapata Corp.*, 714 F.2d 436, 455 (5th Cir. 1983). "The matter is one for the discretion of the district court. The exercise of that discretion is presumptively correct, subject to reversal only where abused." *Zimmerman*, 800 F.2d at 391.

In an effort to camouflage his collateral attack on the findings made by the *Shields* court, Respondent concedes that the *Shields* court's judgment is valid. In the next breath, however, Respondent argues that the judgment is the product of collusion and a fraud on the court. This argument flies in the face of the very determination the *Shields* court was required to and did make; namely, that there was no fraud or collusion in arriving at the settlement agreement and that the agreement was reached through arm's length negotiations. *See Zimmerman*, 800 F.2d at 391; *Maher*, 714 F.2d at

3. Creditors, however, are not without a remedy. The Bankruptcy Code provides that certain transfers of the corporation's rights within 90 days or one year of a bankruptcy's filing can be avoided. 11 U.S.C. § 547. Respondent offers no explanation why these well-known remedies do not fully protect creditors when a derivative action is allegedly settled "on the eve of bankruptcy."

455. Respondent's erroneous and inconsistent argument was accepted by the Court of Appeals and, in this respect also, its decision conflicts with those of other circuits.

D. Respondent Ignores That The Very Purpose Of Rule 23 And 23.1 Is To Provide A Full And Fair Opportunity To Litigate.

Respondent argues that despite the observance of Rule 23 and 23.1 by the *Shields* court, ICA did not have a full and fair opportunity to litigate. Adequate representation, notice and an opportunity to be heard are required by Rule 23 and 23.1, and are specifically designed to satisfy the due process requirement of a full and fair opportunity to litigate. *See Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 812 (1985). There is no dispute that these requirements were met. Thus, there can be no dispute that ICA had a full and fair opportunity to litigate in the *Shields* action. The Court of Appeals' decision to the contrary is simply wrong.

Not only is the Court of Appeals' decision wrong, it conflicts with the court's own decision in the companion case of *In re Imperial Corp. of America*, 92 F.3d 1503 (9th Cir. 1996). There, the Court of Appeals necessarily determined that ICA had a full and fair opportunity to litigate when it held that the FDIC's claims were barred by res judicata. Respondent's brief in opposition does not even attempt to address this obvious conflict.

Respondent argues that the *Shields* case did not involve a typical derivative action settlement under Rule 23.1 because all of the parties were motivated to obtain the court's approval of the settlement. This, however, is the rule rather than the exception. For example, *Oracle*, a case involving a motion to approve the settlement of combined class and derivative litigation, explains that the court is well aware the shareholder plaintiffs and derivative defendants' interests are aligned to gain the court's approval of their settlement when they move for approval of a settlement. *Oracle*, 829 F. Supp. at 1185. This alignment of the interests of the opposing parties creates a departure from the presentation a court normally receives under our adversarial system. Thus, *Oracle* also explains: "Under FRCP 23.1, *the court* has a duty to determine

whether the settlement reasonably protects the interests of the corporation and its shareholders." *Id.* (emphasis added).[4]

Contrary to Respondent's argument, United States District Judges are not blind to the motives of the parties to a derivative settlement. Judges are capable of discharging their duties to independently review and evaluate derivative case settlements. Here, it is undisputed that Magistrate McCue was not only knowledgeable and experienced in handling such matters, but also actively participated in the settlement process. That the parties were motivated, as always, to achieve court approval of the settlement did not deprive ICA of a full and fair opportunity to litigate.[5]

II. THE RESOLUTION OF THIS CASE TURNS ON FEDERAL, NOT STATE, LAW.

While arguing that *Shields* involved an extraordinary Rule 23.1 case, Respondent also contends this case is just an ordinary state law malpractice action with which the Court should not bother. This entire argument, however, requires the Court to dismiss altogether the importance of Rule 23.1 and the derivative nature of the *Shields* action.

As a derivative action, the corporate rights at issue were being enforced by the Shareholder Plaintiffs, not Shea & Gould.[6] The

4. Wright, Miller & Kane, in the very same paragraph from which Respondent lifted his quote, explain: "In determining whether a particular settlement meets [Rule 23.1 requirements], *the court is obligated to consider all of the evidence and it cannot rely solely on the advice of the attorneys before it.*" 7C WRIGHT, MILLER & KANE, FEDERAL PRACTICE AND PROCEDURE § 1839, p. 186 (2d ed. 1986) (emphasis added).

5. Respondent also appears to assume that judges do not read. It is undisputed that in an October 26, 1989 letter, sent four months before the settlement's approval, the Shareholders' counsel argued to Judge McCue that ICA's capital was "impaired" which "will result in the seizure of the institution by federal regulatory officials" unless its capital is improved. CR 865 Ex. 23 at 3.

6. Respondent and the Court of Appeals rely heavily on ordinary state law (Cont'd)

proper resolution of the vital issues of federal law raised by this petition moot the state law issues concocted by Respondent.

III. A CONFLICT EXISTS AMONG THE CIRCUITS.

Respondent attempts to minimize the conflict among the circuits created by the Court of Appeals' decision. In fact, by accepting Respondent's arguments, the Court of Appeals has created a major conflict and opened major new questions in the jurisprudence concerning all derivative actions and court-approved settlements under Rule 23.1.

Where it was previously clear that the shareholder who brought a derivative action represented the corporation's interests as plaintiff, the Court of Appeals now suggests that corporate counsel, whom every court recognizes is adverse to the shareholder plaintiffs and typically aligned with the defendants, also represents the corporation's interests as plaintiffs. Where it was previously clear that creditors had no standing in derivative cases, the Court of Appeals has suggested that corporate counsel can be held liable for not representing the *creditors'* interests. Where it was previously clear that adherence to Rule 23 and 23.1 assured a full and fair opportunity to litigate, the Court of Appeals held it does not.

Further, the Court of Appeals' decision directly conflicts with *Laskey v. International Union*, 638 F.2d 954 (6th Cir. 1981) in nearly every material respect. Respondent's attempt to distinguish *Laskey* because it "addressed only a single, oblique paragraph to the malpractice claim" is nonsensical. Indeed, Respondent's alleged claim against Shea & Gould occupies only one paragraph and one count of his 209 paragraph, 21 count complaint, the remainder of which is devoted to allegations and alleged claims against the other parties to the *Shields* settlement — the Shareholder Plaintiffs, the Officer and Director defendants and D&O carriers.

(Cont'd)
malpractice claims where the plaintiff's lawyers were held to be estopped from relying on judgments resulting from their malpractice. Here, Shea & Gould did not represent ICA as a plaintiff. Therefore, these cases are inapposite.

Contrary to Respondent's characterization, Shea & Gould did not cite *Kamilewicz v. Bank of Boston Corp.* to illustrate a conflict among the circuits. Instead, *Kamilewicz* shows that Court of Appeals' decision did not go unnoticed by Judge Easterbrook, who observed that the door had been opened for collateral attacks on Rule 23 - and Rule 23.1 - approved settlements under the rubric of malpractice. The opening quote from the *Los Angeles Daily Journal* tends to support Judge Easterbrook's observation.

Finally, Respondent argues that this petition should be denied because it is too soon to tell whether issue preclusion exists, claiming that additional discovery is needed. Res judicata would become virtually worthless, however, if cases needed to be litigated to a conclusion just to determine whether preclusion exists.

CONCLUSION

As shown above and in Shea & Gould's petition, the Court of Appeals erred seriously over Rule 23 and 23.1 and erroneously declined to give the *Shields* court's findings preclusive effect to bar this collateral attack on the *Shields* judgment. At the same time, the Court of Appeals created a conflict among the circuits concerning Rule 23 and 23.1 and the preclusive effect of findings made in judgments approving settlements under Rule 23 and 23.1. This conflict goes to the heart of how federal courts insure fairness and finality in the resolution of the extremely complex shareholder actions that increasingly consume their dockets.

Shea & Gould and Sheldon Camhy respectfully request that their petition for writ of certiorari be granted.

Respectfully submitted,

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